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No. 99-258

IN THE

Supreme Court of the United States

CONNECTICUT GENERAL LIFE INSURANCE COMPANY, *et al.*,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Third Circuit

REPLY BRIEF FOR PETITIONERS

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REPLY BRIEF FOR PETITIONERS

1. The brief in opposition scarcely even mentions the question decided by the court of appeals and presented in the petition for certiorari. The court of appeals unequivocally held that courts must defer to agency litigating positions interpreting ambiguous *regulations* (Pet. App. 14a-15a), even though *Bowen v. Georgetown University Hospital*, 488 U.S. 204, 212-13 (1988), prohibits deference to agency litigating positions interpreting ambiguous *statutes*. The petition for certiorari demonstrated that the court of appeals' holding creates two independent circuit splits (Pet. 9-16), conflicts with several of this Court's administrative law and tax decisions (Pet. 16-23), and addresses a question of surpassing national importance (Pet. 23-27). The IRS's observation that there is no circuit conflict regarding construction of 26 C.F.R. §§ 1.1502-47(m)(3)(vi) and (m)(4) (Opp. 7) misses the point that there *is* a circuit conflict on the far more important question whether courts must defer to agency litigating positions interpreting ambiguous regulations. The IRS disputes neither the existence nor the importance of that broader circuit conflict. As twelve extraordinarily diverse *amici* have explained, that broader conflict plainly warrants this Court's attention:

> What is specifically at stake here is the balance of litigating power between taxpayer and tax collector in a large number of cases—those involving the proper interpretation of ambiguous Treasury regulations—and, more generally, between the regulator and the regulated in all areas in which federal regulatory power is exercised and the government's regulation is ambiguous. This is a fundamental issue that is worthy of this Court's consideration.

Brief *Amici Curiae* of the American Council of Life Insurance *et al.* at 7 (filed Oct. 12, 1999).

2. The IRS opposes review based on grounds neither decided by the court of appeals nor raised in the petition for certiorari. Specifically, the IRS contends that its disputed

interpretation was compelled by the "plain language" of the relevant tax regulations (Opp. 10-11) and was authoritatively expressed prior to the tax court litigation in this case (Opp. 11-12). These arguments are unsound at every turn: they ignore the question actually decided by the court of appeals, one of them is untimely, and both of them are meritless.

a. The IRS's argument about the merits of the underlying interpretive dispute (Opp. 10-11) is entirely beside the point, for the court of appeals did not reach that question. As explained in the petition (Pet. 3-6), the underlying dispute involves a question whether the appropriate tax treatment for acquired groups is governed by 26 C.F.R. § 1.1502-47(m)(3)(vi), which establishes a general consolidation rule for any nonlife "member," or by 26 C.F.R. § 1.1502-47(m)(4), which "[r]eserved" the consolidation question in the specific context of "[a]cquired groups."[1] The court of appeals did not itself interpret either provision. Instead, it held only that the competing interpretations were "equally likely" (Pet. App. 16a), and that the IRS's litigating position was therefore entitled to deference (Pet. App. 16a-17a). Indeed, the court of appeals repeatedly limited its analysis to deference issues. *E.g.*, Pet. App. 1a-2a (deferring to IRS's "permissible interpretation"); Pet. App. 13a-15a (discussing deference holdings of *Bowen* and *Gardebring v. Jenkins*, 485 U.S. 415, 430 (1988)); Pet. App. 15a ("we will defer to the IRS's interpretation"); Pet. App. 23a (deferring because IRS interpretation "is not so unreasonable as to be declared invalid by this court").

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[1] As the court of appeals summarized the competing contentions, petitioners construed subsection (m)(4) as a reservation of the acquired group "subject matter" (and thus argued that the sepcific provisions of subsection (m)(4) qualify the general provisions of subsection (m)(3)(vi)), while the IRS construed subsection (m)(4) as a reservation only of "space" for possible future regulations (and thus argued that the general provisions of subsection (m)(3)(vi) qualify the specific provisions of subsection (m)(4)). Pet. App. 15a-16a.

Petitioners seek review of the deference question that the court of appeals did resolve, not the underlying interpretive dispute that it expressly did not reach.

In any event, the IRS errs in contending that its disputed interpretation is compelled by the plain meaning of the regulations. By applying subsection (m)(3)(vi) both to individually-acquired companies and to acquired groups, the IRS's litigating position violates the basic interpretive presumption that "specific provisions qualify general ones," *Robertson v. Seattle Audubon Soc.*, 503 U.S. 429, 440 (1992), and that courts must "give effect, if possible, to every clause or word" of a statute or regulation, *Moskal v. United States*, 498 U.S. 103, 109-10 (1990) (quotation omitted). At a minimum, these principles establish a reasonable interpretive dispute about whether the acquired group issue is governed by subsection (m)(3)(vi) or by subsection (m)(4). The court of appeals resolved that dispute not by construing those provisions itself, but by deferring to the IRS's litigating position.[2]

b. The IRS also errs (Opp. 11-12) in opposing review on the ground that it had authoritatively expressed the disputed interpretation prior to this litigation. The court of appeals did not defer on the ground that the IRS had expressed its interpretation prior to the litigation. Instead, it deferred on the ground that an administrative interpretation of an ambiguous regulation is entitled to deference "even when that interpretation was proffered for the first time in litigation."

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[2] Contrary to the IRS's suggestion, this Court would not need to resolve the underlying interpretive dispute on the merits were it to grant review on the deference question presented. If this Court were to hold that the court of appeals improperly deferred to the IRS's litigating position, it could, if it desired, simply remand the case for the court of appeals to impose its own best construction of subsections (m)(3)(vi) and (m)(4), and of 26 U.S.C. § 1503(c)(2).

Pet. App. 15a. Again, the IRS simply ignores the question decided below and raised in the petition for certiorari.

The IRS also failed to preserve this contention below. In the court of appeals, petitioners argued that the IRS's disputed interpretation was a "litigating position" that, under *Bowen*, was not entitled to deference. Brief for Petitioners-Appellants at 28, *Connecticut General Life Ins. Co. v. CIR*, CA3 No. 97-7612 (filed April 15, 1998). The IRS's sole argument in response was that, because the plain meaning of the regulations compelled its interpretation, no deference question was presented. Brief of Appellee at 21-34, *Connecticut General Life Ins. Co. v. CIR*, CA3 No. 97-7612 (filed May 29, 1998). The IRS did not raise below and the court of appeals did not address any argument for deference based on the IRS's pre-litigation positions. Therefore, the IRS cannot raise that argument here. *See, e.g., Matsushita Elec. Indus. Co. v. Epstein*, 516 U.S. 367, 379 n.5 (1996); *Granfinanciera, S.A. v. Nordberg*, 492 U.S. 33, 38-39 (1989).

In any event, the IRS's argument for deference based on its pre-litigation positions is plainly without merit. The very studies now trumpeted by the IRS (Opp. 11) demonstrate that, prior to this litigation, the IRS had interpreted the regulations in a manner directly contrary to its current litigating position. Those studies reveal that the IRS has long recognized that subsection (m)(3)(vi) could be read either to govern acquired groups, an interpretation described by the IRS in its studies as "alternative one," or not to govern acquired groups, an interpretation described by the IRS as "alternative two." Supp. App. 3a.[3] They further reveal that the IRS not only sought to codify "alternative two" in unambiguous new regulations, but also concluded that "alternative two" was the *more* plausible

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[3] The supplemental appendix to this reply brief ("Supp. App.") reproduces a memorandum (CA3 App. 204-14) setting forth the IRS's pre-litigation interpretation of subsections (m)(3)(vi) and (m)(4).

interpretation of the *existing* regulations (*i.e.*, subsections (m)(3)(vi) and (m)(4)). Supp. App. 5a. The IRS thus affirmatively embraced the position urged in this case by petitioners:

> *Treat the reservation for acquired groups at § 1.1502-47(m)(4) as meaning that there was no rule in effect* for taxable years for which returns were due prior to the formal adoption of alternative two. . . . For periods for which no rule is in effect, any reasonable interpretation of [26 U.S.C.] section 1503(c)(2) as applied to acquired groups (including the interpretation of either alternative one or alternative two) will be acceptable.

Supp. App. 5a (emphasis added).[4]

Equally meritless is the IRS's plea for deference (Opp. 12) based on the position it had staked out during petitioners' audit. The IRS's audit positions are not entitled to deference, because Congress has explicitly provided that any deficiency assessed during an audit is subject to a *de novo* "redetermination" in the United States Tax Court. 26 U.S.C. § 6213(a); *see* Rules of Practice and Procedure for the United States Tax Court, 26 U.S.C. foll. § 7453 (providing for *de*

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[4] The "alternative two" position previously embraced by the IRS, and urged in this litigation by petitioners, reflects a reasonable interpretation of the governing statute, 26 U.S.C. § 1503(c)(2), which provides only that the losses of a recently-acquired nonlife member "shall not be taken into account" for the specific purpose of "determining the taxable income of a member taxed under section 801" (*i.e.*, a life member). Petitioners used the relevant losses not to offset the *life* income of CGL, but only to offset the *non*-life income of members of the INA Group and the PHC Group. Pet. 6-7. In its pre-litigation studies, the IRS conceded that this interpretation of § 1503(c)(2) is both "reasonable" and "acceptable." Supp. App. 5a.

novo trials); *Freytag v. CIR*, 501 U.S. 868, 890-91 (1991).[5] Thus, the Fifth Circuit has held that *Bowen* prohibits deference to IRS litigating positions asserted in the United States Tax Court, *see CSI Hydrostatic Testers, Inc. v. CIR*, 103 T.C. 398, 408-09 (1994), *adopted and aff'd*, 62 F.3d 136 (5th Cir. 1995) (per curiam), even though such litigation necessarily involves review of an audit and the resulting "deficiency," *see id.* at 399. Similarly, the Federal Circuit has refused to defer to IRS interpretations "issued at a time when the I.R.S. is preparing to litigate," *AMP, Inc. v. United States*, 185 F.3d 1333, 1338 (Fed. Cir. 1999), a rule that obviously precludes deference to IRS audit positions.

c. In response to petitioners' further contention that any ambiguity in the regulations should be resolved in favor of taxpayers, the IRS argues that *Gould v. Gould*, 245 U.S. 151 (1917), and its progeny were implicitly overruled in 1938. Opp. 12-13. However, at least seven courts of appeals have continued to apply those decisions. Pet. 12-14 & n.9 (collecting cases). The IRS also argues that, in any event, *Gould* is inapplicable because this is a "deductions" case. Opp. 13-14. However, the consolidation questions presented here have nothing to do with the scope of any particular deduction.[6]

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[5] Because any deficiency assessed during an audit is "subject to a subsequent trial of the law and the facts de novo in a court," taxpayers receive none of the procedural protections that customarily apply during administrative adjudication. 5 U.S.C. § 554(a)(1). Moreover, because Congress explicitly authorized *de novo* review of audit determinations, a tax audit also is fundamentally unlike the administrative adjudication at issue in *Martin v. OSHRC*, 499 U.S. 144, 154-55 (1991), where Congress was presumed to have authorized only a more limited standard of review "for consistency with the regulatory language and for reasonableness."

[6] As noted above (*see supra* note 2), were this Court to grant certiorari and hold that the court of appeals improperly deferred to the IRS's litigating position, it could, if it desired, simply remand the case for the court of appeals to resolve these other interpretive disputes.

3. As demonstrated in the petition for certiorari (Pet. 9-11), at least five courts of appeals have held, in direct conflict with the decision below, that *Bowen* prohibits deference to agency litigating positions interpreting ambiguous regulations. A recent decision from another court of appeals has exacerbated this circuit conflict. In *Public Citizen v. Carlin*, 184 F.3d 900 (D.C. Cir. 1999), the D.C. Circuit deferred to an agency litigating position interpreting an ambiguous regulation promulgated by the Archivist of the United States. "That the Archivist's interpretation comes for the first time in litigation," the D.C. Circuit concluded, "does not make it unworthy of deference." *Id.* at 911. The Third Circuit decision cannot be brushed aside as an aberrational result subject to explanation on meritless grounds that the Third Circuit never considered. The circuit conflict is real, is worsening, and is now ripe for resolution in this Court.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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October 1999

SUPPLEMENTAL
APPENDIX

Internal Revenue Service
MEMORANDUM
CC: LR-128-83
Br2: KEStanley
Date: [Preliminary draft of 6-18-85]

To: Review Group

From: Director, Legislation and Regulations Division

[illegible]: Life-Nonlife Consolidated Returns: CIGNA Issue

Section 1503 (c) (2) provides a limitation on the use of nonlife company losses against life company income on a life-nonlife consolidated return.

STATUTES

Section 1503 (c) (1) provides as a general rule that the consolidated net operating loss of nonlife members (nonlife CNOL) that cannot be carried back against nonlife income may reduce life income (in year the loss arises or as a carryover) but only to the extent of 35 percent of the lesser of the nonlife CNOL or the consolidated life company income.

Section 1503 (c) (2) provides that, notwithstanding section 1503 (c) (1), "a net operating loss" for a taxable year for a nonlife company "shall not be taken into account in determining the taxable income" of a life company unless the loss arises after the nonlife company has been a member for five years.[1]

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[1] There is another "five-year rule" in section 1504 (c) (2). While life companies are not generally treated as members of groups that contain nonlife companies, a life company may be included in a life-nonlife consolidated return, but only if the life company has otherwise been a member of the group for five years.

This memorandum uses the term "ineligible nonlife member" to identify a non-five-year nonlife company.

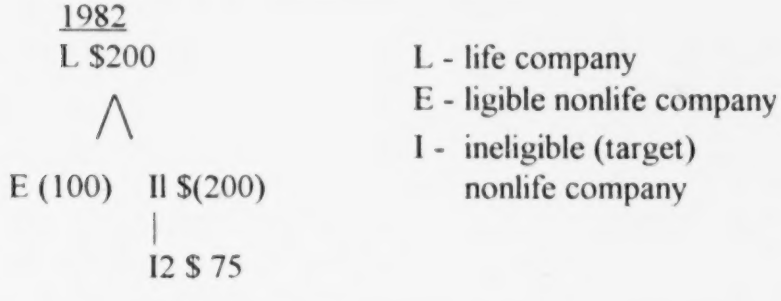
ISSUE, ILLUSTRATION, AND ALTERNATIVES

Issue

In interpreting section 1503 (c) (2), under what circumstances does proper policy dictate that the taxable income of an ineligible nonlife member reduces the net operating losses (NOLs) of other ineligible nonlife members rather than first being used to reduce the NOLS of eligible nonlife members? This issue arises frequently in the consolidated return context, *i.e.*, whether to treat more than one corporation as one entity (single economic entity approach) or to treat them as separate entities (separate entity approach).

Illustration

Assume that L, below, purchases on January 1, 1982, the stock of Il which owns I2 and that I1 and I2 filed a consolidated return prior to their acquisition.



The nonlife CNOL for 1982 is $225, *i.e.*, ($100) + ($200) + $75. If it is assumed that E has no prior year income against which any of the nonlife CNOL could be absorbed as a carryback, then any nonlife CNOL attributable to E (but not to Il) is eligible for use against L's income. How is I2's income applied against the losses of E and I1?

Alternatives

Alternative One (Separate Entity Approach):

Apply section 1503 (c) (2) on a separate entity approach across-the-board. If I1 and I2 were unrelated prior to their independent acquisition by L, the portion of the nonlife CNOL attributable to E would be $25 under the current life-nonlife regulation (§ 1.1502-47 (m) (3) (vi)), *i.e.*, nonlife CNOL of $225 reduced under section 1503 (c) (2) by "not taking into account" I1's NOL of $200. This same rule can be applied even though I1-I2 filed a consolidated return prior to acquisition by L. In such a situation, I2's income in 1982 in effect is applied first against the "eligible" NOL of E. Thus, $200 of the nonlife CNOL is attributable to I1 and $25 of the nonlife CNOL is eligible for use against life income.

Alternative Two (Economic Entity Approach):

Apply section 1503 (c) (2) by treating I1 and I2 as a single economic entity. If I1 and I2 were treated as a single economic entity in 1982, E's share of the $225 nonlife CNOL would be $100, i.e., $225 reduced by the $125 CNOL of the I1-I2 "economic entity."

BACKGROUND

The issue presented in this memorandum was first raised by the CIGNA life-nonlife insurance group only about a month prior to the 3-14-83 deadline for promulgation of the final life-nonlife regulations. The proposed life-nonlife regulations had provided for the use of alternative one in all cases. CIGNA argued that alternative two be adopted for certain acquired nonlife groups.[2]

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[2] CIGNA's facts are that in March, 1982, the holding companies of Connecticut General (CG, primarily a life group but with substantial casualty subsidiaries) and Insurance Company of North America (INA, almost exclusively a casualty group) consolidated into a new entity,

When this issue was presented to the Commissioner a few weeks prior to 3-14-83, he was sympathetic on policy grounds with the use of alternative two in certain cases. However, because those people briefing the Commissioner believed at the time that it was questionable whether there was legal authority to adopt alternative two, the Commissioner decided to go with alternative one's literal reading of the statute for all cases.[3] Nonetheless, the final regulations specifically reserved a rule, entitled "acquired groups," and the preamble indicated that the Treasury would study the issue.[4]

There is no clear-cut, winning argument for either alternative one or alternative two. The legislative history is scanty. Either alternative is viable. Treasury is on record as supporting alternative two.[5]

CIGNA. Former shareholders of CG received about 52 percent of CIGNA stock, resulting in CG being considered the acquiring group and its casualty companies the "eligible" nonlife companies (which had net losses of about $140 million). Former shareholders of INA received the remainder of CIGNA stock and each former INA casualty company is "ineligible" (ineligible taxable income was about $110 million and ineligible NOL's were about $170 million for a net loss of $60 million). For 1982, CIGNA's nonlife CNOL was about $200 million and consolidated life income was about $82 million. Prior to the consolidation, it is not clear whether CG or INA was the larger group.

[3] It is now, however, sufficiently clear that the Secretary does have authority to adopt alternative two. See pp. 5-7 of this memorandum.

[4] The final regulations at § 1.1502-47 (m) (3) (vi) (A) adopts alternative one as the general rule. The final regulations at § 1.1502-47 (m) (4) reserves space for possible future special treatment for "acquired groups." The preamble to the final regulations at 48 FR 11440 discusses these points. See Appendix B.

[5] See Appendix E for copies of two memoranda from Treasury on this issue.

PROPOSED RESOLUTION

The following recommendations are made:

(1) Adopt alternative two for prospective application. The position should be published as a proposed regulation. See section 1503 (a).

(2) Treat the reservation for acquired groups at § 1.1502-47 (m) (4) as meaning that there was no rule in effect for taxable years for which returns were due prior to the formal adoption of alternative two. See section 1503 (a). For periods for which no rule is in effect, any reasonable taxpayer interpretation of section 1503 (c) (2) as applied to acquired groups (including the interpretation of either alternative one or alternative two) will be acceptable.

LEGAL AUTHORITY

It is arguable that alternative one follows the "plain meaning" of the words of section 1503 (c) (2). Thus, the Service has legal authority to adopt this alternative under section 7805. The Service probably also has legal authority under section 1502 to adopt alternative two.

Alternative One

Section 1503 (c) (2) states, in part, that "a net operating loss ... of [an ineligible nonlife member] ... shall not be taken into account in determining the taxable income of [an eligible life member]...". Alternative one deals with the existence of ineligible nonlife loss members by comparing the situation as it would exist in the absence of such members with the situation as it actually exists once such members are included. In this way, this alternative arguably follows the "plain meaning of section 1503 (c) (2) which provides that the NOL of an ineligible nonlife member is not to be taken into account.

Alternative Two

While the Service probably has legal authority under the broad legislative grant of section 1502 to adopt alternative two, it is arguable that the "plain meaning" of section 1503 (c) (2) overrides the general authority of section 1502, especially since section 1503 (c) (2) is a specific, later-enacted consolidated return statute. There is, however, nothing conclusive in the legislative history to indicate whether Congress would have, had it considered the issue, preferred alternative one or two. Furthermore, the meaning of section 1503 (c) (2) is not perfectly "plain".[6] Accordingly, it is not at all unreasonable to conclude that the Secretary has authority under the broad section 1502 delegation of authority (discussed below) to adopt alternative two. It is arguable also that the delegation of authority to the Secretary in the first sentence of section 1503 (c) (1) is sufficient to permit the adoption of alternative two.

Section 1502 authority. The Secretary has a broad legislative grant of authority under section 1502 as to how to take income and losses of the group's members into account. Section 1503 (c) (2) arguably is silent on how to take an ineligible nonlife member's income into account. The Service position is that the Secretary has authority under section 1502 to develop ordering rules for absorption of a particular member's income. For example, § 1.1502-42, T.D. 7876, filed March 14, 1983, adopted a subgroup method under that authority for purposes of determining bad debt deductions for thrift institutions filing consolidated returns. A subgroup method for life-nonlife returns would treat certain ineligible nonlife members as a subgroup for purposes of first off-setting

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[6] The now-rejected allocation approach in alternative three (set forth at pages 4-5 of the 2-1-85 memorandum to the Review Group) arguably also is, along with alternative one, a "plain meaning" approach to section 1503 (c) (2). The existence of more than one "plain-meaning" approach means that the meaning actually is not perfectly "plain."

the income of one or more of its members against the losses of one or more other members of that subgroup. Thus, that subgroup would essentially be treated as if it were a single member for purposes of applying section 1503 (c) (2).

The Service has already used its broad section 1502 authority in a closely related context. That is, in the life-nonlife regulations at § 1.1502-47, the Service takes the position that it can use its section 1502 authority to provide an expansive definition of the term "member" to effectuate the two five-year rules.[7] Basically, the regulations provide (through their definition of eligible corporation at § 1.1502-47 (d) (12)) that for purposes of sections 1503 (c) (2) and 1504 (c) (2) a corporation is not considered a five-year member unless, in addition to formal existence for the five-year period, it also meets certain other requirements, including, for example, that it not have undergone a "disproportionate asset acquisition" during the five-year period. Thus, the Service has taken an expansive view of the term member in order to prevent taxpayers from circumventing the Congressional intent behind the five-year rules.

Alternative two would, under certain circumstances, treat an acquired nonlife subgroup of members as a single member. Because alternative two is merely another kind of expansive reading of the term "member," it is consistent for the Service to assert that it has authority under section 1502 to adopt alternative two, provided this would reach a more desirable policy result.

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[7] See footnote 1 on page 1 and the accompanying text.

POLICY COMPARISON OF ALTERNATIVES ONE AND TWO

Equity vs. Competition

On the one hand, alternative one appears inequitable if, as the result of an acquisition of a nonlife group having a CNOL, the eligible CNOL of the combined group is less than the eligible CNOL of the acquiring group would have been had the acquisition not been made. For example, using the illustration on p. 2 of this memorandum, under alternative one the acquisition of the 11-12 group, which has a $125 CNOL, reduces what otherwise would have been $100 of eligible CNOL of the acquiring group to $25. If 11-12, however, were able to consolidate into a single corporate shell having a $125 NOL, the result would be an eligible nonlife CNOL of the combined group of $100.

On the other hand, the 5-year rules of sections 1503 (c) (2) and 1504 (c) (2) probably reflect Congressional concern that permitting unrestricted life-nonlife consolidation would have a detrimental impact relating to maintaining competition in the insurance industry generally (i.e., antitrust type concerns).[8] The stronger this Congressional intent, the more justification

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[8] While the legislative history is scanty and does not specifically state what Congressional concern prompted the enactment of the 5-year rules, it seems quite likely that these rules were developed by the Conference Committee in part as a compromise in response to the Senate floor debate on the competition issue. See 122 Cong. Rec. 24,680-90 (1976). That is, agreement was reached that life-nonlife consolidation would indeed be permitted but that the 5-year rules would be inserted to reduce anti-competitive effects, notwithstanding the fact that the 5-year rules to some extent reduce the benefits of consolidation. Congress apparently did not want to go too far in encouraging either the acquisition by life groups (*i.e.*, groups containing one or more life members) of nonlife members or the acquisition by nonlife groups (i.e., groups containing one or more nonlife members) of life members.

there is for the application of alternative one to the acquisition of I1-I2. That is, if this concern is strong, Congress arguably would rather provide a rule (alternative one) that does not encourage the acquisition of the entire I1-I2 group[9] than provide a rule (alternative two) that would treat the acquired businesses of the I1-I2 group in the same way they would have been treated had those businesses instead been organized in a single corporate shell.[10]

It is not clear, however, how strongly Congress was concerned about the anti-competitive effects of life-nonlife acquisitions. The only evidence of concern is the (non-self-evident) language of the statute itself and the dialogue of the Senate floor debate, during which the anti-competition argument was seriously raised by one side but was, by the opposing side, considered relatively unimportant compared to the benefits to be derived from life-nonlife consolidation.

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[9] If the acquiring group (L-E) were primarily interested for business reasons in acquiring only either I1 or I2, alternative two would provide some encouragement to also acquire the member in which it was less interested. Thus, for example, if L-E were primarily interested in acquiring I2, there would be a somewhat greater interest in also acquiring I1 (than there otherwise would have been) in order to offset I2's income, thereby "freeing-up" E's eligible loss.

[10] Furthermore, to the extent that there are legitimate business reasons for organizing businesses in the form of a group (I1-I2) as opposed to within a single corporate shell (I), the taxpayers (I1-I2 vs. I) are not similarly situated, and a difference in tax treatment upon acquisition is not inequitable. In many cases there may be good business reasons for organizing the businesses as I1-I2 rather than as I. For example, it may be desirable to conduct different lines of business in different corporate shells. In the casualty industry, because the stringency of state law requirements (relating to reserves and other matters) varies considerably from state to state, it is sometimes economically desirable to sell even a single line of insurance through several corporations, each incorporated in a state different from the others. Admittedly, however, there are also many cases where the form of organization (I1-I2 vs. I) is more or less fortuitous.

While the enactment of the 5-year rules and of the 35% limitation on the offset of nonlife loss against life income has probably had a dampening effect on certain acquisitions, the adoption of alternative two rather than alternative one is unlikely to be a great stimulus for such acquisition activity because the tax difference between the two alternatives is likely to be a minor factor in comparison to other factors determining the desirability of such an acquisition.

Accordingly, it would not be unreasonable to adopt alternative two for acquired nonlife groups on the rationale that the equity argument is entitled to greater weight than the countervailing anti-competition argument.

Formalistic Consolidations

Another reason for preferring alternative two for acquired nonlife groups is that the adoption of alternative one would, in certain cases, encourage purely formalistic consolidations of the acquired group into a single corporate shell in order to obtain the result that would have occurred had alternative two been adopted. This is not, however, a very strong argument because there are probably not very many cases where it would be feasible to consolidate the acquired group merely to obtain that result.[11]

Other Arguments

Other arguments against the economic entity approach raised by the 2-1-85 memorandum to the Review Group subsequently appear to be relatively insubstantial. These arguments include the SRLY rule inconsistency argument (see Appendix A for an in-depth discussion), the reinsurance argument (see Appendix D), and the outdated section 818 (f)

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[11] See Appendix C for a discussion of the feasibility of consolidation of acquired nonlife groups.

(2) argument (old section 818 (f) (2) is not effective for taxable years beginning after 1984).

RECOMMENDED SCOPE OF ALTERNATIVE TWO

Under alternative two, an acquired "economic entity" is to be treated as a single member of the acquiring group for the purposes of applying section 1503 (c) (2). For these purposes it is recommended that the acquisition of an "economic entity" be considered to occur only where an entire affiliated group that was included on a consolidated return is acquired by acquiring the common parent. While a broader definition of "economic entity" would be theoretically correct,[12] adoption of the broad definition is not recommended for two reasons. First, it would involve either the subjectivity of a "single transaction" test or the requirement of an arbitrary time period such as the complex, one-year consistency period in section 338 (h) (4). Second, it would lend a greater flexibility to tax-motivated acquisition planning by allowing the acquiring group to "pick and choose" among the members of a disposing group.

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[12] Under the broadest theoretically correct definition of "economic entity," two or more acquired members would be treated as an "economic entity," provided that those acquired members were acquired in a *single transaction* from an affiliated group and were included in a consolidated return filed for the period which included the acquisition date. Under this broad definition of "economic entity," the equity argument continues to be valid because, had that "economic entity" instead fortuitously been organized within a single corporate shell, there could well have been a significant difference in the amount of eligible nonlife loss computed under section 1503 (c) (2) (even though the form of organization would make little difference in the computation of aggregate net income or loss).